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SUBJECT: CHINA ANNOUNCES STEEL AND AUTO INDUSTRY SUPPORT PLANS

¶1. (SBU) SUMMARY. The State Council approved industrial support plans for the auto and steel sectors on January 14, the first two of ten industry focused plans to help those sectors hardest hit by the economic slowdown. The measures will support domestic demand, protect employment and promote environmental protection in two of China's largest industries. Auto and steel industry representatives welcomed the announcement, but analysts for both sectors expressed doubts about the success of accelerated consolidation without addressing more systemic problems. A provision to stabilize China's international market share in steel will be watched closely by foreign producers wary of export promotion. END SUMMARY.

¶2. (SBU) At the January 14 State Council meeting, Premier Wen Jiabao approved industrial revitalization plans for the auto and steel sectors. These plans are the second phase of the Government's comprehensive economic support plan, which include the already announced RMB 4 trillion stimulus and an expected technology investment plan. The measures announced by the Ministry of Industry and Information Technology (MIIT) are intended to stimulate domestic demand and employment, but also contain provisions for environmental and technology improvements. While the announcement outlines the type of actions which will be taken, specific details remain to be clarified. Additional support plans are expected to cover ten key industries, including ship building, chemicals, textiles, machinery, and property.

Auto Plan Aims to Spur Consumption, Innovation
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¶3. (SBU) The five-part auto industry support plan includes the following measures: 1) a reduction in the sales tax on vehicles with engines smaller than 1.6 liters from 10 percent to 5 percent and a 5 billion RMB subsidy to encourage farmers to upgrade their low-end vehicles, 2) support for industry consolidation, 3) a 10 billion RMB special fund to promote technical innovation, 4) subsidies to encourage the development of environmentally-friendly cars, and 5) support for the development of proprietary brands and the building of auto and parts export bases. According to Chinese Academy of Social Sciences (CASS) Institute of Industrial Economics Researcher Zhao Ying, the subsidies to the auto industry will be funded by both the central government and local governments.

Focus on Stimulating Domestic Consumption

¶4. (SBU) CASS's Zhao said the short-term goal of the auto industry support package is to respond to the current economic slowdown by increasing domestic consumption. He said the poor performance of China's stock market in 2008 impacted car sales. Many middle class families changed their consumption habits because of income effects, and the growth rate of car sales slowed to 7 percent in 2008 after years of more than 20 percent growth. Nevertheless, he predicted that the recent slowdown in auto sales is temporary. He said the huge domestic market will ensure that car sales will grow in the long term.

Protecting Employment and Environment are Key Goals
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¶5. (SBU) Zhao said one of the primary goals of the auto support plan

is to protect employment. NDRC and China Auto Industry Yearbook reported in 2007 that auto and auto parts manufacturing and services provided roughly 30 million jobs in China. Protecting these jobs is important for maintaining social stability, Zhao noted. He said the Government is also aiming to protect the environment by reducing the sales tax on vehicles with smaller engines and encouraging the development of environmentally-friendly cars.

Doubts about Auto Industry Consolidation

¶6. (SBU) In spite of the Government's plan to promote industry consolidation, Embassy contacts expressed doubts. CASS's Zhao said that he is "not optimistic" about the prospects of auto industry consolidation. He said car factories, as a "backbone" of local economies and major contributor to employment and tax revenue, receive strong support from local governments. Zhao predicted that local governments will be reluctant to support consolidation and that most car companies will survive the economic slowdown. He also noted that the enormous Chinese market is conducive to many companies producing different vehicles for many different customer segments. GM Asia Pacific Public Policy Director David Tulauskas said the Central Government hopes that the economic downturn will push the industry into greater consolidation through bankruptcy but acknowledged that local governments will continue to find ways to support their local auto producers.

Industry Response: GM Welcomes Support Plan

¶7. (SBU) Tulauskas told EconOff that GM's overall response to the industry support measures is positive. He said that GM provided input directly to the NDRC and Ministry of Finance and through the China Association of Automobile Manufacturers. The Central

Government asked GM detailed questions about what other governments around the world were doing to support the auto industry. Several of GM's recommendations were accepted by the Government, including the decisions to cut the sales tax by 50 percent on smaller vehicles and to set a clear end date for the tax incentive to create a sense of urgency. GM believes this large tax incentive should be enough to effectively encourage more vehicle consumption.

¶8. (SBU) Tulauskas said that the 10 billion RMB fund established to spur development of new energy efficient and environmentally friendly vehicles was also a "step in the right direction, and the United States should take it seriously." He said that this large amount of money could put China well on the way to becoming a leader in green vehicles. According to Tulauskas, MOFCOM assured GM that it would be able to apply for this funding on a footing equal with domestic companies. However, he noted the need to get more details on how the fund will be managed before determining its value to GM.

¶9. (SBU) Regarding the 5 billion RMB fiscal subsidy to help farmers scrap old "vehicles" and buy new vehicles with engines smaller than 1.3 liters, Tulauskas said that GM would likely benefit "greatly" from this measure through its joint venture with Wuling Auto, which produces a range of minivans and small trucks. However, he noted that the provision was not fully clear and would likely be left up to the local governments to determine eligibility for the subsidy. He also said that local governments have been instructed to relax requirements on licensing, particularly licensing fees, but noted that the effect of this measure will be a mixed bag as local governments will likely implement in a variety of ways.

Government Plans to Control Steel Production

¶10. (SBU) The steel industry measures are intended to control production, close down out-dated facilities and further consolidate the industry structure. They will include policies to promote mergers and acquisitions and a special infrastructure fund to stimulate technological investment. In an attempt to address industry over-capacity, for the first time there will be a freeze on new production facilities and the government will work to stabilize Chinese steel makers' export market share by adjusting export taxes. Additional measures will modify the iron ore import process,

restructure the sales of steel products, and help to distribute industry risk.

Measures Welcomed; But Consolidation Will Be Tough
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¶11. (SBU) China Iron and Steel Association (CISA) Deputy General Secretary Zhang Jingang welcomed the announcement, which he said reflected input from industry and which replaces a failed attempt to mop up excess supply through a Government stockpile. But industry media report unnamed steel mill sources are underwhelmed and have expressed doubts about the Government's ability to speed up closures of outdated facilities. Steel industry expert Professor Lu Tie of CASS Institute of Industrial Economics says the current low level of consolidation is consistent with an industry in the early phase of development. He considers the Government's consolidation targets ambitious and believes progress will be hampered by China's fiscal and tax system.

We've Heard this Consolidation Song Before...

¶12. (SBU) The Government has long supported steel industry consolidation. Yet China's top 10 producers currently account for only 38 percent of total domestic production, versus 88 percent in the U.S. The reality was that even favored, state-owned firms found it difficult to achieve the scale benefits of mergers as powerful municipal and provincial interests sought to protect their ownership rights, tax revenues and local employment base. The 2005 Anshan-Benxi merger, for example, was delayed several years due to Benxi City Government's feared loss of 70 percent of its tax revenue.

¶13. (SBU) COMMENT. U.S. auto makers with established production bases in China are likely to benefit from the auto industry measures. But efforts to stabilize Chinese steel makers' export market share will be closely watched by U.S. and other foreign producers who will be wary of export promotion in the guise of a domestic support plan. With the economic slowdown, the timing of accelerated consolidation in both steel and autos would at first glance appear opportune, but more fundamental policy and structural issues will continue to frustrate these efforts. END COMMENT.

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